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# Focus Europe

## No room for complacency

The ECB has successfully completed the first month of its EUR60bn per month QE programme. Since the announcement of QE, the impact on financial conditions has been substantial and positive: the exchange rate has weakened markedly, borrowing costs have fallen, and equity and collateral values in general have increased. Not surprisingly, growth and inflation prospects have improved.

Nevertheless, expect the tone to remain dovish at the next ECB press conference on 15 April. There is no room for complacency. The ECB wants to promote confidence in QE, its impact on the economy and the chances to meeting its inflation objective. Hence, it will highlight its commitment to the current pace of purchases.

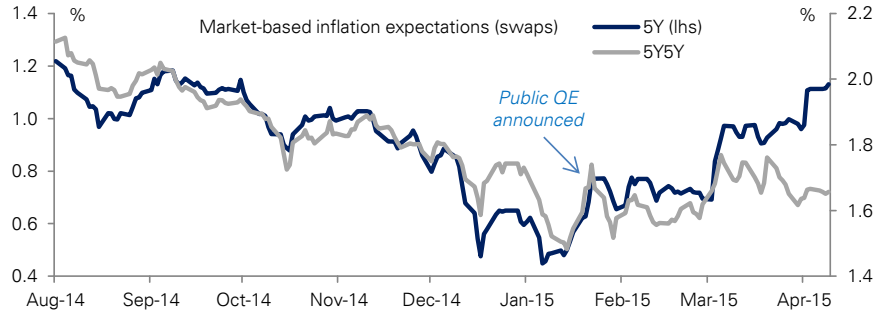
Indeed, the risk of an early reconsideration of the EUR60bn per month for 18 months programme is low. We think it will be the end of the year *at the earliest* before the ECB will be able to judge the appropriateness, one way or the other, of the current QE plan. If anything, the core Council members are keen to present a bias of QE for longer, not an early exit.

The final reading of the euro-area composite PMI for March was revised 0.1 lower, but the index was still up 0.7 on the month to 54.0. Both the PMIs and national surveys point to an increase of 0.4% qoq in euro-area Q1 GDP. Taking account of the hard data, the overall signal is consistent with our +0.5% qoq GDP projection for Q1 2015.

Germany remains on track for a strong Q1 despite mixed hard February data. Despite the mixed industrial data we are not concerned. Our model based on hard data still points to 0.9% qoq GDP growth in Q1 (DBe: 0.8%). The upside risks have disappeared, but Q1 2015 still looks like it was one of the strongest quarters of the last few years for Germany.

There are less than four weeks to go to the UK general election. Another hung parliament looks likely. Based on current polling at least three parties would be required to form a government. This would be easier to achieve for Labour given the likely support in the polls for the Scottish National Party.

Do euro inflation breakevens point to a transitory impact from ECB QE?




*Source: Deutsche Bank, Bloomberg Finance LP*

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## Economic Forecasts

| | Real GDP % growth[b] | | | CPI % growth[c] | | | Current a/c % GDP[d] | | | Fiscal balance % GDP | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F | 2014F | 2015F | 2016F |
| Euroland (top-down) | 0.9 | 1.4 | 1.6 | 0.4 | 0.0 | 1.4 | 2.4 | 3.3 | 2.6 | -2.5 | -2.1 | -1.7 |
| Germany[b] | 1.6 | 2.0 | 1.7 | 0.8 | 0.2 | 1.7 | 7.6 | 8.3 | 8.2 | 0.6 | 0.6 | 0.7 |
| France | 0.4 | 1.1 | 1.6 | 0.6 | 0.1 | 1.1 | -1.0 | -0.5 | -0.8 | -4.4 | -4.0 | -3.4 |
| Italy | -0.4 | 0.6 | 1.3 | 0.2 | 0.1 | 1.1 | 1.8 | 2.5 | 2.7 | -3.0 | -2.7 | -2.2 |
| Spain | 1.4 | 2.5 | 2.3 | -0.2 | -0.6 | 1.5 | 0.1 | 0.7 | 0.5 | -5.6 | -4.5 | -3.7 |
| Netherlands | 0.9 | 1.7 | 1.1 | 0.3 | 0.0 | 1.3 | 10.9 | 11.4 | 11.5 | -2.5 | -2.0 | -1.9 |
| Belgium | 1.0 | 1.3 | 1.6 | 0.5 | 0.2 | 1.6 | 1.0 | 1.5 | 1.2 | -3.0 | -2.7 | -2.2 |
| Austria | 0.3 | 1.2 | 1.8 | 1.5 | 0.7 | 1.7 | 0.7 | 1.2 | 1.5 | -2.3 | -1.6 | -1.2 |
| Finland | -0.1 | 0.8 | 1.4 | 1.2 | 0.1 | 1.3 | -1.9 | -1.5 | -1.3 | -3.4 | -3.3 | -2.8 |
| Greece | 0.7 | 0.8 | 3.2 | -1.4 | -1.6 | 1.0 | 1.0 | 1.5 | 1.2 | -3.5 | -0.7 | -0.7 |
| Portugal | 0.9 | 1.6 | 1.6 | -0.2 | 0.1 | 1.3 | 0.5 | 1.0 | 0.7 | -5.0 | -3.1 | -2.5 |
| Ireland | 4.8 | 3.7 | 3.5 | 0.3 | 0.1 | 1.8 | 4.5 | 5.0 | 4.5 | -4.0 | -2.8 | -2.5 |
| UK | 2.8 | 2.4 | 2.3 | 1.5 | 0.4 | 1.9 | -5.3 | -4.1 | -2.9 | -5.0 | -4.0 | -2.0 |
| Sweden | 2.3 | 2.8 | 2.8 | -0.2 | 0.5 | 1.5 | 6.3 | 5.5 | 5.0 | -1.9 | -1.2 | -0.6 |
| Denmark | 1.1 | 1.7 | 1.8 | 0.6 | 1.0 | 1.5 | 6.2 | 6.0 | 6.0 | -1.0 | -2.5 | -2.5 |
| Norway | 2.3 | 2.0 | 2.2 | 2.0 | 2.0 | 2.0 | 8.5 | 8.0 | 7.5 | 9.1 | 9.0 | 8.5 |
| Switzerland | 2.0 | 1.0 | 1.0 | 0.0 | -0.8 | -0.4 | 8.0 | 8.5 | 8.5 | 0.2 | 0.5 | 0.5 |
| Poland | 3.3 | 3.4 | 3.5 | 0.0 | -0.4 | 1.5 | -1.3 | -1.3 | -1.5 | -3.4 | -2.9 | -2.7 |
| Hungary | 3.6 | 2.7 | 2.4 | -0.2 | -0.3 | 2.5 | 3.6 | 3.5 | 3.5 | -2.9 | -2.7 | -2.4 |
| Czech Republic | 2.0 | 2.6 | 2.5 | 0.4 | 0.3 | 1.9 | -1.0 | -0.8 | -0.6 | -1.3 | -2.1 | -2.2 |
| US | 2.4 | 3.1 | 3.1 | 1.6 | 0.6 | 2.6 | -2.6 | -2.8 | -3.5 | -2.9 | -2.6 | -2.9 |
| China | 7.4 | 7.0 | 6.7 | 2.0 | 1.8 | 2.7 | 3.1 | 3.4 | 3.3 | -2.1 | -3.0 | -3.0 |
| Japan | -0.1 | 0.9 | 1.8 | 2.7 | 0.7 | 0.9 | 0.6 | 3.5 | 3.4 | -5.9 | -5.3 | -4.4 |
| World[e] | 3.4 | 3.4 | 3.7 | 3.7 | 3.3 | 3.8 | | | | | | |

*Sources: National statistics, national central banks, DB forecasts*

## Forecasts: Euroland GDP growth by components and central bank rates

| Euroland, % qoq | 14-Q1 | 14-Q2 | 14-Q3 | 14-Q4 | 15-Q1F | 15-Q2F | 15-Q3F | 15-Q4F | 2014 | 2015F | 2016F |
|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP | 0.3 | 0.1 | 0.2 | 0.3 | 0.5 | 0.4 | 0.4 | 0.3 | *0.9* | *1.4* | *1.6* |
| Private Consumption | 0.2 | 0.2 | 0.5 | 0.4 | 0.5 | 0.4 | 0.4 | 0.4 | *1.0* | *1.8* | *1.4* |
| Gov. Consumption | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | *0.7* | *0.5* | *0.3* |
| Investment | 0.4 | -0.5 | 0.0 | 0.4 | 1.3 | -0.4 | 0.9 | 0.6 | *1.0* | *1.8* | *3.9* |
| Stocks (contribution) | 0.1 | 0.0 | -0.1 | -0.2 | 0.2 | 0.1 | 0.0 | 0.0 | *-0.1* | *0.0* | *0.2* |
| Exports | 0.4 | 1.3 | 1.5 | 0.8 | 0.6 | 1.2 | 1.2 | 1.2 | *3.7* | *4.1* | *5.2* |
| Imports | 0.5 | 1.3 | 1.7 | 0.4 | 1.2 | 1.1 | 1.4 | 1.4 | *3.8* | *4.6* | *5.9* |
| Net Trade (contribution) | 0.0 | 0.0 | 0.0 | 0.2 | -0.2 | 0.1 | 0.0 | 0.0 | *0.1* | *0.0* | *0.0* |
| HICP inflation, % yoy | 0.6 | 0.6 | 0.3 | 0.2 | -0.3 | -0.1 | 0.1 | 0.5 | *0.4* | *0.0* | *1.4* |
| Core inflation, % yoy | 0.8 | 0.8 | 0.8 | 0.7 | 0.6 | 0.7 | 0.8 | 0.9 | *0.8* | *0.8* | *1.2* |
| EMU4 GDP, % qoq | | | | | | | | | | | |
| Germany | 0.8 | -0.1 | 0.1 | 0.7 | 0.8 | 0.2 | 0.4 | 0.3 | *1.6* | *2.0* | *1.7* |
| France | -0.1 | -0.1 | 0.3 | 0.1 | 0.3 | 0.4 | 0.4 | 0.4 | *0.4* | *1.1* | *1.6* |
| Italy | -0.1 | -0.2 | -0.1 | 0.0 | 0.2 | 0.3 | 0.3 | 0.3 | *-0.4* | *0.6* | *1.3* |
| Spain | 0.3 | 0.5 | 0.5 | 0.7 | 0.7 | 0.7 | 0.6 | 0.5 | *1.4* | *2.5* | *2.3* |
| Central Bank Rates (eop) | | | | | | | | | | | |
| ECB refi rate | 0.25 | 0.15 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | | | |
| BoE bank rate | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | | | |
| US Fed funds effective rate | 0.060 | 0.090 | 0.070 | 0.060 | 0.060 | 0.125 | 0.375 | 0.625 | | | |
| PBOC 1Y deposit rate | 3.00 | 3.00 | 3.00 | 2.75 | 2.50 | 2.25 | 2.25 | 2.25 | | | |
| BoJ O/N call rate | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | | | |

(Source: National statistics, national central banks, Haver Analytics LP, DB forecasts. (a) Euro Area and the Big 4 forecasts are frozen as of 27/03/15. All smaller euro area country forecasts are as of 27/03/15. Bold figures signal upward revisions. Bold, underlined figures signal downward revisions. (b) Annual German GDP is not adjusted for working days. (c) HICP figures for euro-area countries/UK (d) Current account figures for euro area countries include intra regional transactions. (e) **The world aggregate has been calculated based on the IMF weights released in October 2014;**

Eurozone | Economics

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# ECB Preview: No room for complacency

- The ECB has successfully completed the first month of its EUR60bn per month QE programme. Whether the ECB will find it as easy to source bonds as the programme progresses remains to be seen. However, the key to the success of QE is the impact on financial conditions. From this perspective, the programme is having a substantial and positive impact: the exchange rate has weakened markedly, borrowing costs have fallen, and equity and collateral values in general have increased.
- Not surprisingly, growth and inflation prospects have improved. Monetary developments, in particular bank credit, validate the view of accelerating economic activity. Euro area GDP probably expanded 0.5% qoq in Q1, the fastest rate of the recovery to date. This would put the euro area on a par with the US in Q1. Still, much of the growth impulse over the last 6 months relates to lower oil prices, the effects of which will be transitory. Beyond lower borrowing costs, the economic benefits of QE are still largely an expectation rather than a reality.
- There is something of a gap in sentiment between the ECB staff optimism – GDP growth to average 2% in 2016-2017 and inflation to be broadly on target in 2017 – and the more prudent ECB Council. The staff forecasts formally encompass the benefits of QE, but policymakers are right to be more reserved. QE is a non-standard policy of which Europe has no experience. The impact is uncertain, all the more so at longer horizons. Moreover, the ECB is not in full control of financial conditions, as the recent stalling of euro depreciation demonstrates. In any case, as both Mario Draghi and the latest ECB minutes say, the objective is a sustainable correction in inflation, not just bring inflation in on target in 2017.
- The tone will likely remain dovish at the next ECB press conference on 15 April. There is no room for complacency. While the ECB wants to promote confidence in QE, its impact on the economy and the chances of meeting its inflation objective, the Council remains appropriately reserved. This means the risk of an early reconsideration of the EUR60bn per month for 18 months programme appears low. We think it will be the end of the year *at the earliest* before the ECB will be able to judge the appropriateness, one way or the other, of the current QE plan. If anything, the core Council members are keen to present a bias of QE for longer, not an early exit.

## ECB successfully completed EUR60bn of asset purchases in first month of QE

This section is a summary of a note published by Abhishek Singhania, DB Fixed Income Strategy[1].

The ECB published the country breakdown of amounts and weighted average maturity of purchases in its Public Sector Purchase Programme (PSPP) for the month of March. Total purchases for the month of March amounted to EUR 47.4bn with supranationals accounting for 5.7bn (i.e. 12% of the total). EUR 12.4bn of covered bond purchases and ABS purchases on top took the total purchases to the EUR 60bn monthly target of the ECB.

Of the 19 countries in the Eurozone, ECB did not purchase any public sector securities in Greece, Cyprus and Estonia. Public sector securities in Greece are not eligible collateral for regular ECB refinancing operations. In the case of Cyprus, securities are not eligible as a review of the EU-IMF programme is currently in progress. In the case of Estonia, lack of eligible securities is likely to be the reason for the lack of any purchases.

The capital key share of the 3 countries excluded amounts to 3.4% which has been redistributed across the other 16 Eurozone counties. The purchases in the major Eurozone countries is about 4% higher than their capital key share of the total amount of PSPP excluding supranational. There are some significant deviations from the capital key share for some of the smaller countries such as Lithuania, Luxembourg, Latvia and Malta.

The details of the purchases in the month of March are suggestive of a marginally more aggressive start than we would have anticipated.

The share of purchases in countries which are either ineligible for the PSPP or do not have sufficient securities is redistributed towards other countries rather than supranationals. This would suggest that if the programme hits limits for some of the larger core countries such as Germany it would imply an increase in proportion of purchases of peripheral securities. This is not relevant for now but is nevertheless suggestive of a potentially more powerful credit easing if QE needs to be continued for longer than currently anticipated.

Figure 1: ECB PSPP details for March

| Country | Amount (EUR mn) | Amount / Total excl supras (%) | Capital key share (%) | Purchase share / capital key share (%) |
|---|---|---|---|---|
| Germany | 11,063 | 26.5 | 25.6 | 103.8 |
| France | 8,752 | 21.0 | 20.1 | 104.3 |
| Italy | 7,604 | 18.2 | 17.5 | 104.3 |
| Spain | 5,444 | 13.1 | 12.6 | 104.0 |
| Netherlands | 2,486 | 6.0 | 5.7 | 104.9 |
| Belgium | 1,527 | 3.7 | 3.5 | 104.1 |
| Austria | 1,215 | 2.9 | 2.8 | 104.5 |
| Portugal | 1,073 | 2.6 | 2.5 | 104.0 |
| Finland | 774 | 1.9 | 1.8 | 104.1 |
| Ireland | 721 | 1.7 | 1.6 | 104.9 |
| Slovakia | 506 | 1.2 | 1.1 | 110.6 |
| Slovenia | 209 | 0.5 | 0.5 | 102.2 |
| Luxembourg | 183 | 0.4 | 0.3 | 152.3 |
| Latvia | 75 | 0.2 | 0.4 | 44.9 |
| Lithuania | 39 | 0.1 | 0.6 | 15.9 |
| Malta | 5 | 0.0 | 0.1 | 13.0 |
| Total excl. supras | 41,676 | 100.00 | 96.62 | 103.5 |
| Supras | 5,680 | | | |
| **Total** | **47,356** | | | |

*Source: Deutsche Bank, ECB*

## Economic growth: The outlook is much improved, but the benefits of QE have still be to proven

We now preview the ECB Council meeting on 15 April.

Growth prospects have improved markedly. Since December, we have raised our 2015 and 2016 euro area GDP growth forecasts by 0.6pp each to 1.4% and 1.6% respectively. The consensus has converged to this level according to the latest Consensus Economics Inc survey — with the most recently changed forecasts within the survey averaging 1.5% and 1.9% respectively.

A considerable portion of the optimism can be traced to the easing of financial conditions that the ECB has achieved in the lead up to and then the initial implementation of QE.

Figure 2: Euro area growth prospects have improved

**Real GDP growth forecasts, %**

| | 2015 | 2016 |
|---|---|---|
| DB | 1.4 | 1.6 |
| Consensus* | 1.4 | 1.7 |
| Consensus^ | 1.5 | 1.9 |
| ECB staff | 1.5 | 1.9 |

**Consensus Economics Inc, ^latest changes within Consensus Economics Inc survey group*
*Source: Deutsche Bank, ECB, Consensus Economics Inc*

[1] See "ECB QE: Breakdown of purchases in March 2015", DB Fixed Income Research Special Report, 7 April 2015.

The depreciation of the euro may have stalled over the last month, but we estimate that the c15% decline in the euro trade weighted index over the last year — especially since late last year — could add roughly 0.3pp and 0.5pp to GDP growth in 2015 and 2016 respectively.

The stronger form of monetary policy is arguably boosting bank lending by raising banks' appetite for loan credit risk and boosting collateral values. Bank margins are being compressed by policy action and real economy borrowing costs are falling as a result. Since the start of last year the rates that non-financial corporates have to pay for bank loans have fallen by 75bp. This could add about 0.1-0.2pp to GDP growth per annum.

Lower rates have pushed equities higher too. The 15% rise in euro area equity indices since asset purchasing began in September could translate into a 0.3-0.4pp rise in GDP this year even allowing for the euro area's lesser sensitivity to equity wealth[2].

The recovery has momentum. At 0.3% qoq in Q4, GDP growth was back in line with trend, helped by private consumption. Our forecast is for GDP growth of 0.5% qoq in Q1, the fastest quarter of the recovery to date and the first above-trend quarter. But lower oil prices are still the principle driver of activity, as they were in Q4.

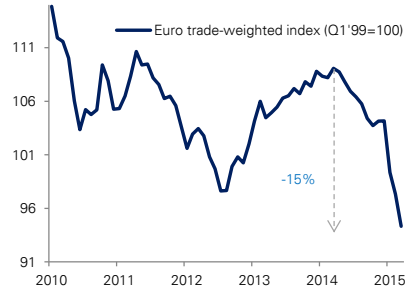
The feed through of easier financial conditions is expected to boost demand increasingly as the year progresses. The benefits of a more competitive currency take time to feed through, for example. Our forecasts of 1.4% and 1.6% GDP growth in 2015 and 2016 capture our conservative optimism that QE will create growth and help the cyclical recovery wean itself off the benefits of lower oil prices. They also try to capture some of the political uncertainty that could weigh on growth (for example, in Spain around year-end).

The data continue to support the relative optimism. Both the PMIs and national surveys point to an increase of 0.4% qoq in euro area GDP in Q1 2015. When we encompass the euro area hard data, we see picture as consistent with our 0.5% qoq GDP projection. This week's German orders report for February was weaker than expected at the headline level, but the details continued to emit positive signals, for example, on German consumer demand and euro area investment demand. Similarly, German IP might have reduced the upside risks to Q1 growth, but is still consistent with German GDP growth of 0.8% qoq. There remains some upside risk in Q1 in other countries, for example, Spain.

While QE creates upside risk to our GDP forecasts, there is reason for caution. While we wait for QE to prove its impact on demand — and this is necessarily uncertain — the lack of external momentum remains a key vulnerability. Since mid-2014, despite lower oil prices, global growth outside the euro area has declined.

A one standard deviation shock to external demand has three times the impact on euro area GDP as a one standard deviation shock to the exchange rate, according to work done by the ECB staff[3]. To put this into context, broadly speaking, the strong decline of the euro trade weighted index might only be enough to compensate for the weakening of external demand.

Figure 3: QE has eased financial conditions, not least via a weaker exchange rate




*Source: Deutsche Bank, ECB*

Figure 4: Real economy borrowing costs are falling too


*Source: Deutsche Bank, ECB*

Figure 5: Combining the real data with the surveys, we believe Q1 GDP will expand by 0.5% qoq

| | Q1 | | |
|---|---|---|---|
| Country | Composite PMI | National Surveys | DB |
| Euro area | 0.4 | 0.4 | 0.5 |
| Germany | 0.5 | 0.6 | 0.8 |
| France | 0.1 | 0.1/0.3 | 0.3 |
| Italy | 0.0 | 0.2/0.3 | 0.2 |
| Spain | 0.6 | 0.8 | 0.7 |

*Source: Deutsche Bank, Markit, various national sources*

[2] See "Euro area private consumption: is there a role for housing wealth effects", ECB Working Paper Series # 1057, May 2009.

[3] See "Modelling the impact of external factors on the euro area's HICP and real economy: a focus on pass-through and the trade balance", ECB Working Paper #789, July 2007.

## Inflation: Expectations of a turning point

Considering that the relationship between growth and inflation is uncertain, caution on the recovery should translate into double caution on the outlook for inflation.

Headline HICP inflation has most probably troughed. Having fallen to a low of -0.6% yoy in January, headline inflation has recovered to -0.1% yoy in March. It would require a strong decline in oil prices from current levels to push headline inflation to new lows.

It will be another 3-6 months before we can confidently say that core HICP inflation has troughed. Core inflation returned to the cycle low of +0.6% yoy in March. We forecast core to go no lower than this, but with normal volatility it will still take a few months to be convinced that core is moving even slower off this floor.

Our view is that the FX decline to date is sufficient to bring HICP inflation in, broadly speaking, on target in 2017. The deprecation to date is enough to add about 0.5pp to HICP inflation in 2017 — the elasticity we assume is consistent with the mid-point between the staff's high and low estimates — and ex-FX inflation we estimate at about 1.3-1.5%. The ECB staff forecast for inflation in 2017 is also 1.8%.

The fit between movements in the euro trade weighted index and movements in core HICP goods price inflation might suggest that the ordinarily close relationship broke down in 2012. We are not convinced that the 2012 episode is relevant, however.

In 2012, the currency fell in the context of an existential crisis. Risk premia were high, the economy was receding, confidence was weak and household income was stagnating. It was not an environment conducive to passing through rising import prices. The environment this year is the opposite.

There are reasons to believe that core good price inflation is at or about a turning point. Our colleague Markus Heider uses a 3-step process to assessment the net impact on euro area HICP of imported inflation.

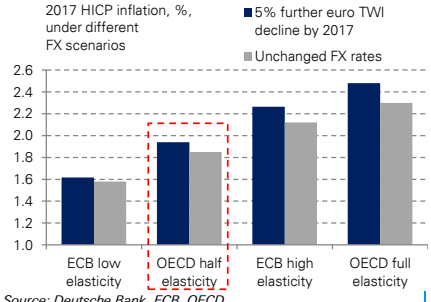
Step 1 is to model euro area import prices on the basis of commodity prices and output price inflation in the euro area's main import partners. Step 2 is to model domestic output prices on the basis of import prices and domestic economic trends. Step 3 is to model HICP inflation on the basis of import prices and domestic output prices. The current indications are that a turning point has been reached and core goods HICP inflation should start moving higher.

There are also signals of a tentative turning point in the selling price balances in the retail sector surveys, for example, the monthly Commission survey.

Lags combined with natural volatility mean a convincing turn in the inflation cycle will take time to emerge. It is sensible for the ECB to play it cautiously. Neither the 5Y or 5Y5Y breakeven inflation rates are back to normal levels. In fact, while the 5Y has continued to rise, the 5Y5Y has dropped back to the middle of the post-QE range. This was mentioned in the latest ECB minutes.

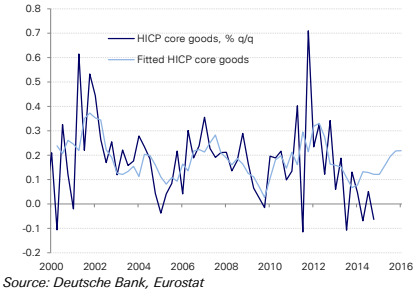
Although just one (and imperfect) measure of inflation expectations, skeptics could use inflation breakevens to argue that the inflation benefits of a weaker currency won't last.

Figure 6: There is reason to believe HICP inflation will be on target in 2017 thanks to FX depreciation



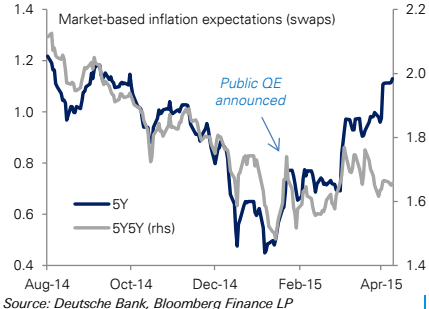
*Source: Deutsche Bank, ECB, OECD*

Figure 7: Imported inflation is helping to signal a turning point in core inflation



*Source: Deutsche Bank, Eurostat*

Figure 8: The emerging gap between 5Y and 5Y5Y inflation expectations questions the sustainability of the inflation impact of QE



*Source: Deutsche Bank, Bloomberg Finance LP*

## Private sector credit: Potential upside risk to the economic recovery

As we described recently in Focus Europe, there is broad consistency between the cyclical picture portrayed in the surveys and what is implied by the euro area money and credit data[4].

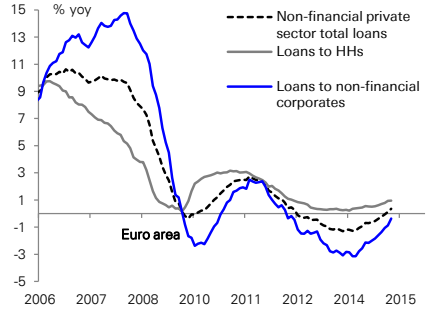
The flow of credit to the private sector has been positive for the last 3 months, the first consistent positive period since early 2011. Within this, the flow of loans to the private sector has been positive for 4 months (and positive for 5 of the last 6 months). Within this, the flow of loans to households has been positive for virtually all of the last year. The flow of loans to corporates is turning more positive, with two positive months in the last 3.

The composition of corporate lending is itself turning more positive. Short-term loans (up to 1 year and 1 to 5 year) have on average grown over the last year. The overall contraction in lending to the corporate sector was driven by long term loans (over 5 years). But the flows of long term loans have been positive in 2 of the last 3 months. This is consistent with the message from the Bank Lending Survey of net positive demand for loans for fixed asset investment.

We use the credit impulse to think about the relationship between credit and economic growth. The credit impulse is the second derivative of lending to the real economy – the changing flow of credit is what best correlates with economic growth. Earlier last year it was sufficient for the slower deleveraging post-AQR to push the second derivative of credit higher, consistent with the persistent if generally slow economic recovery. As the private sector loan flows begin to turn positive, the credit impulse is pushing higher once again.

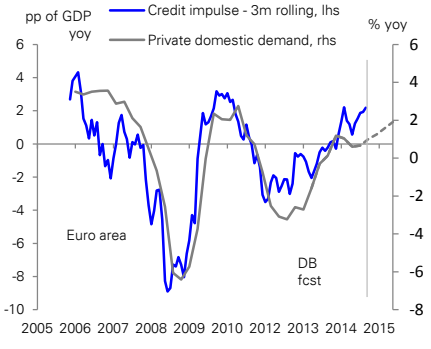
In February, the euro area credit impulse is back to the mid-2014 peak, implying momentum in domestic demand and arguably some upside risk to our baseline GDP forecast (currently 1.4% for 2015). Credit conditions, as captured by the Bank Lending Survey, suggest there may be upside risk for the credit impulse, reinforcing the upside risk to economic growth.

Figure 9: In month-on-month terms, corporate loan flows have been positive in 2 of the last 3 months



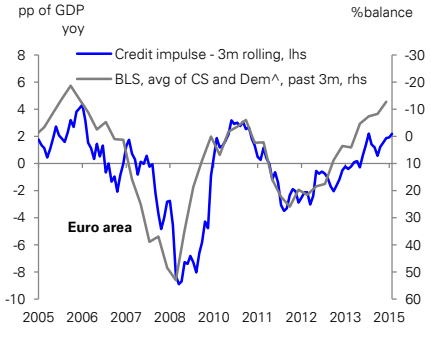

*Source: Deutsche Bank, ECB*

Figure10: The euro area credit impulse is back to the 2014 peak, and implies upside risk to demand




*Source: Deutsche Bank, ECB, Eurostat*

Figure11: The Bank Lending Survey reinforces the upside risk




*Source: Deutsche Bank, ECB*

We will be scrutinizing the next BLS on 14 April closely for signs of continuing support for the economic recovery.

[4] See "Euro area surveys and credit data point to domestically driven recovery", Focus Europe, 27 March 2015.

## ECB to stay on-message: committed to 18 months of QE, with risks skewed towards a longer programme

One of the more frequent questions we are being asked is whether the ECB might end or taper the EUR60bn per month QE before its scheduled end date in September 2016.

The exact wording of the ECB policy is as follows: EUR60bn per month of asset purchases are "intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term".

The rhetoric could have been stronger. It is only an "intention" to conduct purchases until September 2016, not an unconditional commitment. This softer rhetoric might have been a necessary compromise with the hawks to agree a larger monthly total than the market expected with a larger degree of risk-sharing.

We have continually argued that the exchange rate was the main transmission channel for public QE in the euro area. The depreciation of the euro to date will help the ECB bring back inflation to target, as we argued above. However, our FX Strategists believe EUR/USD will fall to parity by year-end, 90 cents in 2016 and a new cycle low of 85 cents in 2017.

A much-faster-depreciation of the exchange rate could become "too much of a good thing". A depreciation of EUR/USD to 0.85 would, ceteris paribus, push 2017 inflation to between 2.1% and 2.9% based on the above ECB multiplier. The central estimate (2.5%) would be materially above target[5].

However, it is possible to square the circle between resolute implementation of trillion euro plus QE and a material euro depreciation (i) if there has been a structural break in the GDP-FX-inflation relationship or (ii) if the euro-area is subject to a shock that increases the FX risk premium without affecting the central GDP path, such as Grexit.

Recent comments by Executive Board Member Mersch highlight the potential for an earlier end to QE, but there is a danger of overestimating his comments. He said that ECB projection of 1.8% HICP inflation in 2017 was conditional on QE lasting until September 2016 and added "if we see that we are going beyond that figure, it would of course be appropriate to consider whether we need to adjust our plan".

There are several reasons to downplay the potential for an early tapering or ending of QE.

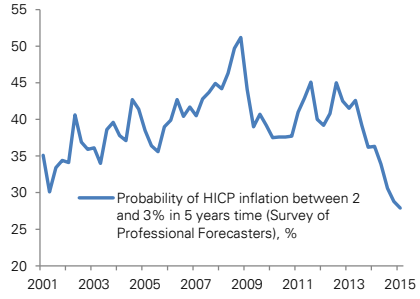
First, Mersch, who is one of the more hawkish members of the Governing Council, took a more balanced position than this one quote implies: "Incidentally, that also applies should we not come close to the target. We cannot in either instance turn our eyes from reality". That one of the few hawks is talking about the symmetry of risk to QE tells us that the balance of the Council is on the dovish side.

[5] See "Too much of a good thing", Focus Europe, 13 March 2015.

Second, Mersch is not in favour of sudden moves. He described ECB policy as "oriented towards smooth developments" and was clear that exit was not on the Council's mind: "I am convinced that we have not yet arrived at a point where we need to conduct a public discussion on the exit". With minutes now published, even Council meetings count as a public discussion[6].

Third, whether an 18 month QE is appropriate or not will not be determined on the basis of 2017 inflation alone. As ECB President Draghi told the European Parliament on 23 March, the ECB will take a "holistic perspective" when assessing the path of inflation: the ECB "will evaluate the likelihood for inflation not only to converge to levels that are closer to 2%, but also to stabilise around those levels with sufficient confidence thereafter". Since confidence in future projections necessarily declines the further ahead one looks — an argument the Council made in the latest minutes — it will take time for the Council to be able to judge whether such a stabilization around the target level is being confidently achieved.

Figure 12: A sustainable correction in inflation is not yet evident in the surveys




*Source: Deutsche Bank, ECB*

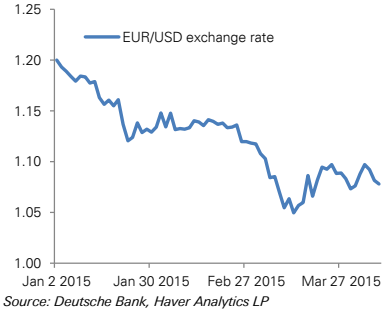
Fourth, the recent appreciation of the EUR/USD exchange rate shows the danger to the ECB of modifying the policy message on the ebb and flow of financial markets rather than proven economic conditions. Many determinants of financial conditions are outside the ECB's control. The ECB must be patient and as such must maintain high commitment to QE.

If there was one key message in the latest "accounts" (minutes) of the 4-5 March ECB Council meeting it was that there are "no room for complacency" despite the firming of growth and the confidence embedded in the ECB staff growth and inflation forecasts.

In the opinion of the Council, the benefits of QE, including euro depreciation, will "likely unfold with some delay". The timing and extent are both uncertain. The Council talked of "prudent optimism". There was a strong vein of caution.

The Council acknowledged the upward revision to the staff forecasts for growth came "in significant part" from the assumed benefits QE. But the Council also acknowledged the higher degree of uncertainty surrounding the transmission of non-standard policies, "also in view of limited and mixed evidence, thus far, on the impact of earlier non-standard measures".

Figure 13: The recent stalling of EUR/USD depreciation urges caution on the ECB: QE needs resolute implementation




*Source: Deutsche Bank, Haver Analytics LP*

In our view, it will be year-end at the earliest before the ECB will be able to start judging the appropriateness of an 18 month QE programme. Given the multiple uncertainties, at this point there is no reason to believe the ECB would not deliver the full 18 months. Indeed, we think it appropriate the ECB stresses its capacity to go further if necessary.

This message of longer-if-necessary is not just implicit — for example, Draghi's comments about inflation achieving a sustainable correction, not just returning to target in 2017 — it is explicit. During the Q&A at the 5 March ECB press conference, Draghi said: "at this point in time, we see absolutely no reason to think or plan or act in any different way from what we've planned, namely the purchasing of EUR60bn a month of securities until September 2016, or beyond, if needed". Draghi's rhetoric is stronger than just an 'intention' to purchase until September 2016.

[6] Mersch's interest in "smooth developments" is consistent with our view that the ECB wants the market to get used to QE for reasons other than the current downside risks to inflation. Arguably, the refi policy rate won't have fully normalised by the time the euro area next goes into recession. Chances are, QE will become a standard monetary policy tool. The ECB cannot afford to switch QE on and off at a whim. Smooth transition and market predictability is important. This view of the likely standardisation of QE as a policy tool is consistent with the latest warnings from the IMF about weak potential growth, lower equilibrium interest rates and the constraints of the lower bound of policy rates.

The same longer-if-necessary bias came from another influential member of the Executive Board, Benoit Coeure: the ECB will purchase sovereign debt through the third quarter of next year "and maybe beyond that if necessary" (MNI, 12 March 2015). Coeure did not balance his comment by hinting at the possibility of an earlier exit.

In conclusion, the tone will remain dovish at the next ECB press conference on 15 April. There is no room for complacency. While the ECB wants to promote confidence in QE, its impact on the economy and the chances to meeting its inflation objective, the Council remains appropriately reserved.

## And finally, Greece: it is all about the rules

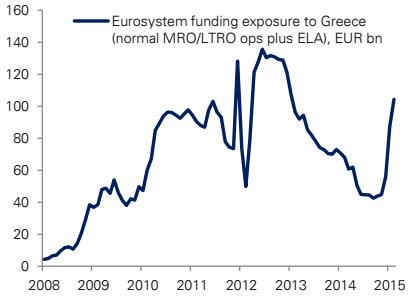
The waiver on Greek collateral is highly unlikely to be re-instated before the Eurogroup meeting on 24 April at the earliest. The Eurogroup Working Group (EWG) is said to have given Greece 6 working days (from Thursday 8 April) to deliver the comprehensive list of reforms of even a partial disbursement of aid is to be agreed at the Eurogroup meeting on 24 April[7]. This means the ECB Council won't be in a position to discuss at the 15 April policy meeting.

The newswires also report a further rise in Greek ELA of EUR1.2bn to EUR72.3bn, implying total Eurosystem funding for Greece is rising close to EUR110bn[8]. This once again demonstrates the ECB's capacity for flexibility.

However, we continue to stress that the ECB's flexibility is dependent on politics. We believe capital controls are a material risk and interpret Eurogroup President Dijssebloem's recent comment on capital controls as something of a political green flag if the ECB's tolerance becomes exhausted.

Bundesbank tolerance of Greek ELA is declining. Jens Weidmann is not only opposed to raising the T-bill limit within ELA, he argues that any ECB financing of T-bills could be considered monetary financing if the sovereign has clearly lost access to the market[9]. In his Borsen-Zeitung interview on 8 April, Yves Mersch said the Council had not reached a conclusive opinion on the matter. The uncertainty reinforces the message to Greece that progress needs to be made on a deal with the Eurogroup if the central bank's funding constraints are to be relaxed.

Figure 14: Eurosystem exposure to Greece creeps higher




*Source: Deutsche Bank, ECB*

[7] See Kathimerini, "Greece has six working days to present new reform proposals", 9 April 2015.
[8] See Kathimerini, "Extra 1.2 bln in ELA for Greek banks seen as just covering outflows", 9 April 2015.
[9] See Bloomberg, "ECB Increases Greek ELA Ceiling by 600 Million Euros", 12 March 2015.